

REPORT BY THE  
AUDITOR GENERAL  
OF CALIFORNIA

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**THE DEPARTMENT OF CORPORATIONS'  
ADMINISTRATION OF CONVERSIONS  
OF HEALTH CARE SERVICE PLANS  
TO FOR-PROFIT STATUS**

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OFFICE OF THE AUDITOR GENERAL

F-606

THE DEPARTMENT OF CORPORATIONS' ADMINISTRATION  
OF CONVERSIONS OF HEALTH CARE SERVICE PLANS  
TO FOR-PROFIT STATUS

JULY 1986



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Thomas W. Hayes  
Auditor General

July 23, 1986

F-606

Honorable Art Agnos, Chairman  
Members, Joint Legislative  
Audit Committee  
State Capitol, Room 3151  
Sacramento, California 95814

Dear Mr. Chairman and Members:

The Office of the Auditor General presents its report concerning the Department of Corporations' administration of the conversions of health care service plans from nonprofit to for-profit status. The report indicates that the Department of Corporations has complied with the law relating to the approval of conversions and has applied its departmental procedures objectively and consistently.

Respectfully submitted,

  
THOMAS W. HAYES  
Auditor General

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## SUMMARY

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### RESULTS IN BRIEF

The Department of Corporations (department) is responsible for approving the conversions of nonprofit health care service plans (health plans) to for-profit status. Through its interpretation of the law governing conversions, the department requires the new for-profit organization to donate the value of the old nonprofit health plan to charity. We reviewed four of the nine conversions approved after 1983 to determine whether the department complied with the law and applied departmental procedures objectively and consistently. In all four cases, the department used appropriate valuation methods, obtained reasonable donations for charities, and ensured that the charities received the donations.

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### BACKGROUND

Conversions of health plans from nonprofit to for-profit status became possible through a change in the Corporations Code in 1980. From 1980 to 1983, the Attorney General had primary responsibility for administering conversions. The department assumed responsibility for administering the conversions through legislation that became effective in January 1984. The department already had responsibility for administering health plans under the Knox-Keene Health Care Service Plan Act of 1975, as amended. Since 1984, the department has completed nine conversions.

According to the department's interpretation of the Corporations Code, the code requires a nonprofit health plan to donate its fair value to charity when it dissolves. The department has assumed the responsibility for approving the valuation amount, the settlement terms of the donation, and the selection of the charity.

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## PRINCIPAL ISSUES

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The Department Has Followed  
Legal Requirements and Has  
Applied Its Own Procedures  
Objectively and Consistently

The Corporations Code section that permits the conversion of nonprofit corporations to for-profit status does not specify how to administer the conversions. Therefore, the department developed its own procedures for approving applications for conversions. The department has used accepted business valuation methods in determining the fair value of the health plans and has approved donations to charity that were consistently higher than the health plans' proposed donations. In view of the fact that valuations of ongoing businesses depend on estimates and professional judgment, the valuations appear reasonable. However, we did not determine whether the department obtained the highest possible valuations.

The two largest health plans whose conversions the department approved donated their fair value to charities that the health plans created specifically for the purpose of receiving the donation. The department required these charities to be "substantially unrelated" to the converted health plan and prohibited the charities from funding or supporting the for-profit health plan.

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## AGENCY COMMENTS

The Business, Transportation and Housing Agency commented that the report presents a thorough and accurate review of the four conversions. The agency also stated that the department is resolving the two procedural problems mentioned in the report.

## INTRODUCTION

The Department of Corporations (department) is responsible for administering and enforcing the Knox-Keene Health Care Service Plan Act of 1975 (Knox-Keene Act), as amended (California Health and Safety Code Section 1340 et seq.). The intent and purpose of the Knox-Keene Act is to promote the delivery of health and medical care to the people of California who subscribe for the services rendered by a health care service plan (health plan). The provisions of the Knox-Keene Act apply to both nonprofit and for-profit health plans and help to assure the best possible health care for the public at the lowest possible cost by transferring the financial risk of health care from patients to providers.

In 1979, Section 5813.5 was added to the Corporations Code. This section allows a nonprofit health plan to convert to for-profit status by restating its articles of incorporation. Initially, the Attorney General was responsible for approving the conversions of nonprofit health plans to for-profit status. In 1983, revisions to the Corporations Code gave the department sole authority to approve health plan conversions. Since then, the department has approved nine conversions.

By law, the articles of incorporation of a nonprofit health plan must state that the corporation is not organized for the private gain of any person. In addition, the law requires that, when a

nonprofit corporation dissolves, all of its assets be disposed of in conformity with its articles or bylaws. The department requires the converting health plan to donate the fair value of its net assets to a charity whose purpose is similar to that of the health plan.

Appendix B presents a glossary of the terms related to the methods for determining fair value that are discussed in this report.

#### SCOPE AND METHODOLOGY

The purpose of this audit was to review and evaluate the Department of Corporation's process for approving the conversion of health care service plans from nonprofit to for-profit status.

To determine the department's role and responsibilities in the health plan conversions, we reviewed applicable laws, regulations, and policies governing the conversion of health plans. We also reviewed and analyzed criteria related to business valuation techniques and interviewed department staff to identify their procedures for reviewing and approving health plan conversions.

To evaluate the adequacy of the department's process for approving health plan conversions, we compared the department's procedures with the identified criteria. We reviewed the department's procedures for compliance with applicable laws, and we also determined whether or not the department used appropriate business valuation



procedures. We assessed these procedures to determine whether all conversions received objective and uniform consideration by the department.

We reviewed four health plan conversions approved by the department to determine if the department applied its procedures for the health plan conversions consistently. We tested the conversions of the Foundation Health Plan, the Family Health Programs, the Greater San Diego Health Plan, and the Protective Health Providers. In selecting the four health plan conversions for testing, we chose the three largest conversions approved by the department plus one smaller conversion. Besides testing for proper valuation methods and for objective and uniform consideration, we also ascertained whether the department adequately supported and documented the conversion process. Finally, we determined whether the department's process ensured that an appropriate charity would receive the fair value of the converting health plan.

## AUDIT RESULTS

### THE DEPARTMENT OF CORPORATIONS' ADMINISTRATION OF CONVERSIONS OF HEALTH CARE SERVICE PLANS TO FOR-PROFIT STATUS

Since the beginning of 1984, the Department of Corporations (department) has administered the conversions of nine health care service plans (health plans) from nonprofit to for-profit status. In our review of four of the nine conversions, we found that, although the law provides little guidance for the administration of conversions, the department has followed the few legal requirements and has developed its own set of procedures, which it has applied objectively and consistently. The department has used accepted valuation methods to determine whether the valuations proposed by the converting health plans were reasonable and has applied the methods objectively. When the two largest converted health plans donated their fair value to charities that were created for the purpose of receiving the donation, the department required these charities to be "substantially unrelated" to the converted health plan.

Conversions of nonprofit corporations to for-profit status became possible in 1980 through the addition of Section 5813.5 to the Corporations Code, which requires the Attorney General to approve the change in the articles of the public benefit corporation. Until 1983, the Attorney General had primary responsibility for the administration of health plan conversions. Effective January 1, 1984, the addition of

Section 10821 to the Corporations Code shifted the responsibility for the conversions of health plans, but not for other public benefit corporations, to the Commissioner of Corporations. Neither of the sections above provides any guidance for the administration of the conversions.

Section 5130 of the Corporations Code requires a nonprofit public benefit corporation, such as a nonprofit health plan, to state in its articles of incorporation that the corporation is not organized for the private gain of any person. In addition, Section 6716 of the Corporations Code requires a nonprofit corporation, upon dissolution, to dispose of its assets in conformity with its articles or bylaws. From its interpretation of these sections, the department derives its authority and obligation to require converting health plans to donate the fair value of the converting nonprofit health plan to another nonprofit organization. In addition, the department applies the cy pres doctrine in requiring that the donation be made to a nonprofit organization whose purpose is similar to that of the converting health plan. The cy pres doctrine is the doctrine in the law of charities that allows the courts to carry out the general intention of a gift whose purpose is impossible or illegal to carry out. Under this doctrine, the courts can apply the gift to a charitable organization whose purpose is closely related or similar to that of the donor organization.

According to the department's Assistant Commissioner who manages the Division of Health Care Service Plans, the department does not have formal, written procedures governing the conversion process; however, it does follow an informal set of requirements in reviewing and evaluating conversion applications. Most of the department's procedures cover aspects of the conversions not specifically addressed in the law, including the methods for determining the fair value of the converting health plan, the development of reasonable terms for making the donation, and the selection of an appropriate recipient of the donation.

#### Determining the Fair Value of a Converting Health Plan

In each of the four conversions we reviewed, the department required the converting health plan to donate its fair value to a charity so that the directors of the converting health plan could not derive any gain from the health plan while it had nonprofit status. When a nonprofit health plan applies for conversion to for-profit status, the department requests from the health plan an analysis of its fair value. In the cases that we reviewed, the health plans employed certified public accountants, appraisal experts, or financial analysts to prepare these analyses. The department required that the value be determined through standard valuation methods that are commonly used and accepted in the financial community.

In practice, there are many different methods of valuating businesses, but these methods can be divided into three categories. One approach is to value the net assets of the business, including its goodwill, which is an intangible asset that arises from a business's excess earnings power and is generally not shown on the balance sheet. A second approach is to estimate the earnings potential or the discounted value of the cash flow, and a third approach is to estimate the value of the business by comparing it to the market value of similar corporations whose stock is publicly traded. Several valuations of the health plans we reviewed used all three approaches; the results were averaged to arrive at an estimate of fair value.

The estimates of fair value determined by applying these valuation methods may vary significantly. For one thing, the methods themselves can result in significant differences. For another, the same method applied by two knowledgeable individuals can result in very different valuations because each application requires the individuals to use professional judgment, estimates, and assumptions.

For the four conversions that we reviewed, the department favored either the asset-based methods or the earnings-based methods, depending on the circumstances, and preferred to base the fair value on the most appropriate method rather than on a weighted-average value of several methods. Generally, the asset-based method is considered more appropriate when buildings, equipment, and other property have substantial value and provide most of the value of the business. The

earnings-based method is considered more appropriate for determining the value of a service-oriented business with few underlying assets. While the valuation under the asset-based method depends partly on the subjective estimate of goodwill, the valuation under the earnings-based method depends wholly on subjective estimates of expected earnings and capitalization rate. For this reason, the earnings-based approach can show even more variability than the asset-based approach.

After each health plan submitted its valuation analysis, the department reviewed and evaluated the analysis to determine whether the method or methods used were appropriate, whether the estimates and assumptions were reasonable, and whether the analysis reflected the most current data. In three of the four cases that we reviewed, the department rejected the health plans' initial valuations because they did not meet one or more of these criteria. The department required significant changes in the valuation analysis for these three cases; as a result, the health plans made considerably higher donations to charities. In all cases, the department increased the donation and improved the settlement terms that the health plans proposed when they submitted the applications for conversion. Although we did not determine whether the department obtained the highest possible value, we did determine that the department's valuations were reasonable and that the department consistently required the use of appropriate valuation methods.

The following table shows the increase in the dollar value of the donations from the original proposal submitted by the health plans to the final donation approved by the department. (Detailed descriptions of the conversion processes for the four health plans we reviewed are included in Appendix A.)

**ORIGINALLY PROPOSED DONATIONS COMPARED TO  
FINAL DONATIONS APPROVED BY THE DEPARTMENT**

<u>Health Plan</u>	<u>Donation Originally Proposed</u>	<u>Final Donation Approved by Department</u>
Foundation Health Plan	Transfer all shares of stock	\$1,000,000 plus all shares with total guaranteed minimum value of \$10,618,000
Family Health Program	\$13,429,000	\$38,457,000
Greater San Diego Health Plan	\$500,000	\$1,353,379
Protective Health Providers	\$150,000	\$370,000

The table shows that, in three of the conversions, the dollar value of the final donations was more than twice that of the donation originally proposed. The donation of the Foundation Health Plan cannot be evaluated on the basis of the dollar value alone because the donation consisted of 100 percent of its shares. The value of the Family Health Program increased partly because the conversion approval process was lengthy, and, during this time, the value of the health plan increased considerably.

Although we determined that the department was objective in obtaining acceptable donations and settlement terms, we identified one error in the department's calculation of the value of the Greater San Diego Health Plan. Since the department assumed in its valuation a 20 percent growth rate for yearly earnings, it should have added 20 percent to the earnings to each of the five years before discounting the earnings flow to June 30, 1984. Therefore, the correct value should have been 20 percent, or approximately \$270,000, higher than the calculated value. Since the calculated value became the basis for the donation, the department probably would have insisted on the higher amount had it been aware of the error.

In some cases, the valuation amount became the basis for further negotiations. This was the case when the department concluded that the valuation methods did not provide an acceptable value. This situation can occur when a business has a negative equity or when past earnings do not reflect the current earnings power.

The preceding analysis of valuation methods did not address other factors that may influence how the fair value of a business is determined. For example, one business may be willing to pay a premium for a second business whose product or location fit well into the structure of the first business. Competitive considerations could also be a factor in determining the value of one business to another. Some businesses may pay a premium for the human resources of another business. In short, many factors may influence the value of one business to another.



Donation of the Fair Value  
of Net Assets to Charity

The department required the converting health plans to donate their fair value to a charity. We determined that they did make the donations to charities.

Once the department and health plans agreed upon the valuation, the department reviewed the selection of the charity and the terms for paying the donation. Since the converting health plans did not have the cash available to pay the entire donation at the time of conversion, the department allowed them to make a cash down payment and to pay off the remaining balance, including the accrued interest, over several years. One health plan, the Foundation Health Plan, made a cash down payment and donated all shares of the converted health plan to a newly established charity. For all four conversions that we reviewed, the department required agreements guaranteeing that the charity would receive specified amounts of cash each year. The department also required the converting health plans to agree to secure the payments by using their assets as collateral.

The department expressed its concern that the two largest converting health plans, the Foundation Health Plan and the Family Health Program, made their donations to charities that were specifically created for the purpose of receiving the donation. Three of the directors of the Foundation Health Plan became directors of the newly created charity, whose board of directors consisted of seven

members. The Family Health Program put two of its directors on the seven-member board of the new charity it created. To ensure that the newly formed charities were independent of the converted health plans, the department required the bylaws of the newly created charities to state that these charities were created for public and charitable purposes and would not fund or support the converted health plans. In addition, the department required a majority of the charities' directors to be financially unrelated to the converted health plans.

The law does not prohibit a converting health plan from creating a new charity to receive the donation, nor does it address the question of independence between the converting health plan and the charity to which the donation is made. The department concluded that, as long as the charity is "substantially unrelated" to the converting health plan, a donation to the newly created charity is acceptable.

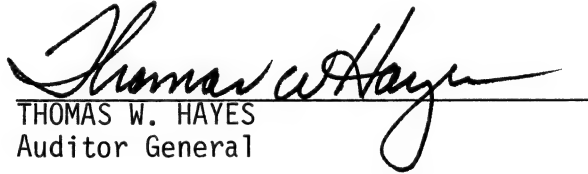
#### CONCLUSION

The law that permits the conversion of nonprofit corporations to for-profit status provides little guidance for administering conversions. Through its interpretation of the law, the Department of Corporations has developed its own procedures for approving the applications for conversion. These procedures include determining the value of the converting health plan and selecting a recipient for the donation. The department has complied with the law and

applied its procedures consistently. The department has used accepted valuation methods and has consistently obtained much higher donations and better settlement terms than those originally proposed by the converting health plans.

We conducted this review under the authority vested in the Auditor General by Section 10500 et seq. of the California Government Code and according to generally accepted governmental auditing standards. We limited our review to those areas specified in the audit scope section of this report.

Respectfully submitted,

  
THOMAS W. HAYES  
Auditor General

Date: July 21, 1986

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## APPENDIX A

### DETAILED DESCRIPTIONS OF THE FOUR HEALTH PLAN CONVERSIONS THAT WE REVIEWED

#### Foundation Health Plan

On September 20, 1983, the Foundation Health Plan (Foundation) submitted an application to the Department of Corporations (department) requesting approval to convert from nonprofit to for-profit status. Included with the application was an analysis of Foundation's fair value and a proposed plan for the settlement of its donation to a charity. On February 3, 1984, after reviewing and evaluating the application, the department approved Foundation's conversion to for-profit status.

Foundation's settlement to charity was accomplished through a series of steps that included stock transfers and a down payment of cash. Foundation created a nonprofit entity, the Sierra Foundation for Health (Sierra), to receive the charitable donation. Once converted to for-profit status, Foundation transferred 100 percent of its stock to Sierra and immediately thereafter created a holding company, the Americare Health Corporation (Americare). Americare then transferred 2,536,148 shares of its stock to Sierra in exchange for all of Foundation shares held by Sierra. As a result, Foundation became a wholly owned subsidiary of Americare, and Sierra was initially the sole stockholder of Americare. In addition to the transfer of all the shares of its stock, Foundation also paid \$1,000,000 cash to Sierra at the time of conversion.

Since Sierra was the principal stockholder of Americare, significant sales of Americare stock held by Sierra could potentially affect the value and control of Americare. To protect the value of Americare and Sierra, the parties entered into a stock restriction agreement. The stock restriction agreement allowed Sierra to sell a certain amount of its Americare stock while at the same time allowing Americare to continue its operations without the impact of substantial sales of its stock. In the first year after conversion, Sierra could sell up to 800,000 shares; in each of the next four years, Sierra was permitted to sell up to 500,000 shares per year. The stock restriction agreement allowed Sierra to exceed these limits if any one stockholder acquired more than 500,000 shares of Americare.

By transferring all of its stock to Sierra, Foundation had donated 100 percent of its value to Sierra. Therefore, the department used the valuation analysis submitted by Foundation only to determine a minimum value of the stock transfer for conversion purposes. The department anticipated that the actual value of the stock, over time, would be much higher than the value established for conversion

purposes. To produce a final value of \$10,618,000, Foundation used an average of five valuation methods: book value, adjusted book value, capitalized earnings, market test, and a valuation of goodwill. The department reviewed the analysis and concluded that acceptable methods were used and that the valuation was reasonable.

To ensure that Sierra would receive at least the minimum value of \$10,618,000 from Foundation, the department required Foundation and its parent corporation, Americare, to sign a guarantee of value agreement with Sierra. The terms of the agreement required Foundation to make a \$1,000,000 cash down payment to Sierra to commence its operations. The agreement also ensured that Sierra would receive a specified minimum amount of cash in subsequent years.

Under the guarantee of value agreement, Sierra would receive at least \$600,000 a year from the sale of its Americare stock in each of the first five years of the agreement. If during any of these years Sierra did not realize the \$600,000 minimum through a public offering, the guarantors, Foundation and Americare, would redeem a sufficient number of shares to provide at least \$600,000 to Sierra for that year. The guaranteed value of \$600,000 is cumulative, i.e., any amount over \$600,000 received in one year would apply toward the requirement for the following year. The agreement also guarantees that Sierra would receive at least \$5,000,000 from the sale of stock at the end of five years. If not, the guarantors would redeem a sufficient number of shares in cash immediately upon the sixth annual anniversary date to provide a total of \$5,000,000 to Sierra.

The guarantee of value agreement contains provisions for determining the value of shares redeemed by the guarantors. Under the agreement, the "redemption price" of Americare shares would be either the last over-the-counter or stock market exchange bid price or, if this is not applicable, a price determined by independent appraisals and mutual agreement of the parties.

When Sierra has received at least \$6,000,000 (\$1,000,000 down payment plus \$5,000,000 in subsequent sales of stock), the market value of the stock held by Sierra that is allowable for sale under the terms of a stock restriction agreement will be determined. If this combined value equals at least \$10,618,000, the guarantee of value agreement is satisfied. However, the guarantee of value agreement cannot be terminated without the prior consent of the department. If the amount of cash received plus the value of stock held by Sierra that is allowable for sale does not equal at least \$10,618,000 on or before the tenth anniversary of the conversion, the guarantors must redeem a sufficient number of shares to provide the guaranteed amount. The value of stock held by Sierra that is allowable for sale will be determined in the same manner as the "redemption price" discussed previously.

Because Foundation donated its value to a charity it created, the department required assurances that the contribution to Sierra would be used for appropriate purposes and that Foundation would not

benefit from the contribution. The bylaws of Sierra state that Sierra was created for public and charitable purposes to fund and support health and health-related activities primarily in Northern California and that Sierra is not to fund or support Foundation either directly or indirectly. Under its bylaws, a majority of Sierra's directors (four of the seven) must be financially independent of Foundation, and no more than three of Sierra's directors can serve on the boards of either Foundation or Americare.

We reviewed Sierra's audited financial statements as of June 30, 1985, to determine the effect of Foundation's conversion on Sierra. Sierra received \$10,672,500 in cash from Foundation, which is more than the guarantee of value agreement required. The total amount of cash Sierra received comprises the \$1,000,000 down payment from Foundation, \$600,000 from shares redeemed by Americare, and \$9,072,500 from sales of stock in a public offering. In addition to the cash Sierra received, the shares of Americare stock that Sierra still owned had an approximate market value of \$52,540,000 based on published market quotations at June 30, 1985. However, the market value is not necessarily indicative of its fair value at that date because Sierra holds a large block of shares (approximately 60 percent of the outstanding common stock of Americare) and because there are restrictions on the sale of these shares.

#### Family Health Program

On February 11, 1985, the Family Health Program (Family) submitted its original application to the department requesting approval to convert from nonprofit to for-profit status. Included with the application was an analysis that valued Family at \$13,429,000 for conversion purposes as of June 30, 1984. The valuation was based on an average of three methods: capitalized earnings, discounted future earnings, and book value. The department concluded that, although the valuation methods were acceptable, the department's review of Family's September 30, 1984, financial statements determined that the analysis did not reflect a current value for Family.

For the same reason, the department also rejected a second analysis submitted on May 29, 1985, which valued Family at \$21,495,000 as of June 30, 1984. The second valuation analysis included a weighted average of four methods: adjusted book value, capitalized earnings, discounted future cash flows, and a market test. Again, the department concluded that although the methods were acceptable, the department's review of Family's March 31, 1985, financial statements indicated that the results of Family's analysis were not based on current enough data.

After more discussion, the department and Family agreed that the CPA firm of Ernst and Whinney should prepare a current valuation of Family. In August 1985, Ernst and Whinney submitted its analysis, which valued Family at \$32,000,000 as of June 30, 1985. Ernst and Whinney used three methods--adjusted book value, capitalized earnings, and discounted future cash flows--plus an estimate of the economic benefit received by Family as a nonprofit entity. Although the

department concluded that all of these methods were acceptable, the department selected the adjusted book value method as the most appropriate method for valuing Family. The adjusted book value method provided the highest value; incorporated the value of Family's land, buildings, and equipment; and included a valuation of Family's goodwill.

Based upon its further review of Ernst and Whinney's analysis, the department determined that Family had a value of \$36,000,000 and issued an approved conversion order dated September 20, 1985. From a review of Family's audited financial statements, the department determined that Family earned between \$1,200,000 and \$1,300,000 per month. When the department issued the conversion order, it added \$4,000,000 to the original valuation of \$32,000,000 to compensate for the amounts earned since June 30, 1985. Because Family continued to earn significant monthly profits, the conversion order was valid only through October 7, 1985.

However, pending litigation prevented Family from converting at that time. Another health plan, the Maxicare Health Plans, Inc. (Maxicare), initially offered to buy Family for \$30,000,000 on September 6, 1985. Maxicare increased its bid to \$50,000,000 on September 26, 1985. Family rejected Maxicare's offers, and litigation followed. Maxicare filed a motion in Los Angeles County Superior Court to prevent Family's conversion unless Family accepted Maxicare's offer, an equal offer, or a better one. Subsequently, the Attorney General filed for, and was granted, a temporary restraining order that prevented Family from converting until the Attorney General could investigate. On October 18, 1985, a Los Angeles County Superior Court judge ruled that "the conversion scheme...doesn't require that a health plan sell to the highest bidder..." and that the legal test is "whether there was fair value." Thus, the court's decision allowed the conversion process for Family to continue.

Because the department's original conversion order had expired, Family submitted an updated application and valuation analysis on November 1, 1985. This analysis updated Ernst and Whinney's earlier valuation, specifically the adjusted book value of Family, to \$36,137,000. The analysis included updates of real estate appraisals and Family's book value. The department added \$2,320,000 to the valuation amount to compensate for profits earned by Family after September 30, 1985; the final result was a valuation of \$38,457,000.

Once the department had determined the value of Family for conversion purposes, the department reviewed the payout terms of the settlement and the propriety of the FHP Foundation, the newly created charity that was to receive the donation. The department required considerable assurances that the settlement terms would be met and that the donation would be made to an appropriate entity. On November 25, 1985, the department issued an approved conversion order that valued Family at \$38,457,000. Because Family continued to earn significant daily profits, the conversion order was valid only through November 27, 1985. Family converted to for-profit status on November 26, 1985.

The payout terms of Family's settlement included a down payment of cash and the issuance of promissory notes for the balance. The terms of the settlement required Family to make a down payment of \$7,200,000 to the FHP Foundation at the time of conversion. In addition, Family executed a promissory note for \$28,800,000 bearing interest at 10 percent per annum. The unpaid principal balance and interest is due and payable in annual installments of \$3,786,445. The first installment will be due on November 26, 1986, with continuous annual payments due on November 26 of each successive year until 1995. Family executed a second promissory note in the amount of \$2,457,000, bearing 10 percent interest payable annually, with the entire principal and interest due on the second anniversary of Family's conversion. This second note may be converted, at the option of the FHP Foundation, into 89,050 shares of common stock of the HMO Health Group, Inc., Family's parent corporation.

In order to assure that the FHP Foundation would receive the payments, the department required a security agreement and a cash pledge agreement between Family and the FHP Foundation. Security for the notes included all of Family's commercial trade account receivables, now owned or hereafter acquired, for health care services to Family's members. As additional security for the notes, Family deposited \$3,786,000 in an account with the Bank of America and pledged these funds to the FHP Foundation.

Because Family created the donee, the FHP Foundation, the department required assurances that the donation would be used for proper purposes and that the FHP Foundation would be substantially independent from Family. The bylaws of the FHP Foundation provide the assurances required by the department. They state that neither Family, its affiliates, nor its principals may be recipients of any charitable grants of the FHP Foundation, and no such charitable grant or expenditure by the FHP Foundation may accrue, directly or indirectly, to the private benefit of Family, its affiliates, or principals. The bylaws also state that the purpose of the FHP Foundation is to support and promote charitable activities in all areas related to health care delivery. They also require that five of the seven directors of the FHP Foundation be independent of and unrelated to Family and its parent corporation.

#### Greater San Diego Health Plan

The Greater San Diego Health Plan (Greater San Diego) submitted an amended application to the department on June 13, 1984, requesting approval to convert from nonprofit to for-profit status. At the same time, the San Diego Private Practice Association (Association), an affiliated mutual benefit corporation, was requesting approval from the Attorney General to convert from nonprofit to for-profit status. In 1983, revisions to the Corporations Code gave the department responsibility for approving the conversion of health plans such as Greater San Diego; however, the law still provided the Attorney General with the authority for approving the conversions of other types of nonprofit entities. Because the Association was not a



health plan, it was required to seek approval for conversion from the Attorney General. The Association serves Greater San Diego as the individual practice association component providing physician and related services to persons enrolled in Greater San Diego. The Association hires and pays physicians for their services and then receives reimbursement from Greater San Diego for these services.

Greater San Diego submitted an original valuation analysis dated February 7, 1984, to the department. The analysis was prepared by the CPA firm of Ernst and Whinney and included a valuation of Greater San Diego and the Association combined. Ernst and Whinney used the combined valuation because of the relationship of the entities and because both were requesting approval for conversion.

The Ernst and Whinney analysis used a combination of two valuation methods and proposed a fair value of \$500,000 for Greater San Diego and the Association. Ernst and Whinney used the adjusted book value and capitalized earnings methods. The capitalized earnings method incorporated projected earnings for the year ending June 30, 1984, adjusted for anticipated increases in physician payment rates. Because Greater San Diego and the Association had net losses in the past, contracting physicians had agreed to accept lower fees in order to keep Greater San Diego and the Association financially viable. According to Greater San Diego representatives, the Association planned to increase the fees paid to contracting physicians during 1984 because Greater San Diego was now profitable.

The department reviewed the Ernst and Whinney analysis and concluded that the valuation did not reflect a high enough value for Greater San Diego and the Association. Using the projected earnings developed by Ernst and Whinney, the department prepared its own valuation analysis using a method that discounted the future earnings to the present value. The department calculated a value of \$1,350,030 for Greater San Diego and the Association combined. Although the department used an acceptable and appropriate valuation method, we found an error in the department's application of this method. The department discounted estimated earnings starting with the year ended June 30, 1984, which represented the year just ended, rather than the following year. As a result, the computation yielded a lower valuation amount. If the calculation had been correct, the department may have insisted on a valuation amount that would have been \$270,000 (20 percent) higher than the calculated value.

After a slight adjustment, the department and the Attorney General established a valuation amount for Greater San Diego and the Association of \$1,353,379, which would be irrevocably dedicated to charitable purposes. With the approval of the department and the Attorney General, Greater San Diego and the Association converted to for-profit status in December 1984.

Greater San Diego and the Association accomplished their settlement to charity by donating \$850,000 to the American Red Cross and \$503,379 to the Child Abuse Prevention Foundation of San Diego

County. Greater San Diego and the Association made a 10 percent down payment to each of the charities and executed promissory notes for the remainder. The promissory notes bear interest at 10 percent per year, with equal payments of principal and interest due semi-annually over a period of nine years. As collateral for the notes, the Association granted a security interest to the charities in all accounts receivable and contract rights that are due or may become due.

#### Protective Health Providers

On August 17, 1983, the Protective Health Providers (Protective) submitted an application to the department requesting approval to convert from nonprofit to for-profit status. Included with Protective's application was an analysis that valued Protective at \$150,000 for conversion purposes. Protective based the valuation on a combination of three valuation techniques: adjusted book value, discounted future earnings, and a comparative analysis of Protective with two other health plans that recently converted to for-profit status. The first two valuation methods produced negative fair values because of Protective's poor financial condition. Consequently, Protective used the comparative analysis approach and developed a positive fair value of \$150,000 for conversion purposes.

The department reviewed Protective's valuation analysis and concluded that it yielded a fair value that was not reasonable. The department felt that Protective had discounted its value too much under the first two valuation methods and that the comparative analysis was an inappropriate method for determining Protective's value. As a result, the department developed its own valuation analysis for Protective using the capitalized earnings method. The department applied various capitalization rates to develop a range of Protective's fair value. The department then met with Protective and negotiated a fair value of \$370,000 for Protective's charitable contribution.

On March 21, 1984, the department approved the conversion of Protective from nonprofit to for-profit status. Under the terms of the conversion, Protective donated its fair value of \$370,000 to the Mercy Hospital and Medical Center (Mercy). The department required Protective to execute a promissory note to Mercy in the amount of \$370,000 with interest of 8 percent per year for seven years. The note required Protective to pay \$35,000 at the time of conversion, \$35,000 plus interest in the first year, and \$50,000 plus interest in each of the next six years. As security for the note, Protective pledged to Mercy as collateral all of its common stock issued and outstanding after conversion. In addition, the department required an agreement between Protective and Mercy that prohibited Protective from receiving any benefit from its donation to Mercy.

GLOSSARY OF TERMS

<u>Terms</u>	<u>Definition</u>
Adjusted Book Value Method of Valuation	This method adjusts the book value of a business, as defined below, to reflect the current market value of its assets and liabilities. This method is appropriate when a business' investment in property, buildings, and equipment is substantial and represents most of its value.
Book Value	This value represents the difference between all of the assets of a business and all of its liabilities as recorded on its balance sheet. However, the balance sheet presents historical costs and does not reflect the current fair value of assets.
Capitalized Earnings Method of Valuation	Under this method, a business' fair value is represented by the present value of an infinite stream of future annual earnings. The mathematical computation requires dividing the estimated earnings level by an appropriate capitalization rate. The level of earnings to capitalize can be developed from an historical average of income or, depending on the circumstances, from present or expected earnings if they are more representative of the earnings potential of the business. The capitalization rate should reflect a reasonable rate of return that is based upon the risk factors associated with the business being valued. This rate can be developed from available market data of comparable businesses or from an analysis of alternative investment possibilities.

Terms	Definition
Discounted Future Earnings Method of Valuation	Under this method, a business' fair value is calculated by discounting projected earnings or estimated cash flows of a business to the present value. Generally, projections of earnings for at least five years into the future are used. The discount rate should represent an appropriate rate of return that includes a normal interest rate plus a risk factor that reflects the overall risks of the business and the inherent risks in the earnings estimate.
Economic Benefit	As used in this report, economic benefit is the financial benefit that a health plan received while it operated as a nonprofit corporation and was exempt from paying income taxes. This benefit includes the amount of taxes that the health plan would have otherwise paid plus the interest that would have accrued on the accumulated taxes.
Goodwill	Goodwill reflects the ability of a business to earn a rate of return on its assets that exceeds the normal rate of return for the industry in which the business operates. The value of goodwill can be determined by dividing the amount of earnings that exceeds a normal return by an appropriate capitalization rate.
Market Test Method of Valuation	This method of valuation can be used to establish the value of a company whose shares are not publicly traded by comparing it to a similar company whose shares are publicly traded. Generally, a market test includes comparisons with businesses that offer a similar product and are comparable in size, dividend-paying capacity, or other factors deemed important.

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**BUSINESS, TRANSPORTATION AND HOUSING AGENCY**

July 17, 1986

Mr. Thomas W. Hayes  
Auditor General  
Office of the Auditor General  
660 J Street, Suite 300  
Sacramento, California 95814

Dear Mr. Hayes:

We appreciate the opportunity to review your draft report entitled "The Department of Corporations' Administration of Conversions of Health Care Service Plans to For-Profit Status." Overall we feel that the report portrays a thorough and accurate presentation of the four conversions which your staff reviewed.

We appreciate your pointing out the procedural problem which resulted in the potential difference in the valuation of one conversion. The legislature had simplified the conversion process in 1984. However, this particular case was complicated by the concurrent conversion of the Individual Practice Association (IPA) by the Attorney General. The valuation was for the combined entities and the entire transaction including the combined valuation required the concurrent approval of the Attorney General. This led to a delay in finalizing the conversion of the plan.

The Department of Corporations has already instituted procedures to assure that this situation does not repeat itself. The current policy requires that financial statements be continually submitted during the review process and that the projections be revised to reflect the current level of activity as well as to bring them up to date. Once a valuation amount is determined a time frame is established during which the transaction must be completed. For example, in a recent conversion the original DOC order was valid only through October 7, 1985 but since the transaction could not be completed by such date the valuation had to be adjusted. The second approval which was granted on November 25, 1985 was only valid if the plan actually converted by November 27, 1985 for the same reason.

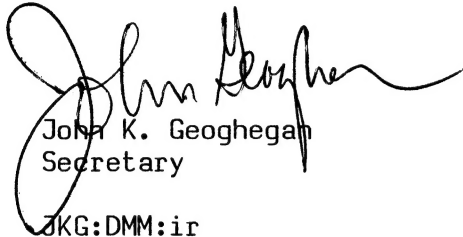
Mr. Thomas W. Hayes  
Auditor General  
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July 17, 1986

In reference to the comments regarding the Department's absence of formal written procedures governing the conversion process, the Department is currently in the process of preparing a conversion manual. Each conversion is very unique and must be evaluated based upon the specifics of the particular company. However, we do recognize the need for a formal written manual outlining the process and explaining the various issues involved.

The report prepared by your staff represents a very complete job of analyzing a complicated and detailed matter. We appreciate the thoroughness of your review.

Sincerely,



John K. Geoghegan  
Secretary  
JKG:DMM:ir

cc: Members of the Legislature  
Office of the Governor  
Office of the Lieutenant Governor  
State Controller  
Legislative Analyst  
Assembly Office of Research  
Senate Office of Research  
Assembly Majority/Minority Consultants  
Senate Majority/Minority Consultants  
Capitol Press Corps